

## PERAC HOSTS 3rd ANNUAL EMERGING ISSUES FORUM

PERAC held its third annual Emerging Issues Forum focusing on "Ethical Dilemmas in Public Stewardship" at Holy Cross College on June 22, 2006.

Massachusetts' Inspector General Gregory G. Sullivan headlined the event which is designed to showcase developing issues of importance to the public pension community. In addition to Sullivan, nationally renowned ethics experts Dr. Sheldon S. Steinberg and David T. Austern, Esq., as well as governance specialist Dr. Dennis Logue and fiduciary attorney Alan P. Cleveland addressed the gathering of 160 retirement board members, administrators, and vendors.

"On behalf of the Commission and its staff," said Joseph E. Connarton, PERAC Executive Director, "I would like to thank our speakers as well as those who took the time to attend. We believe that these sessions represent an opportunity to target a hot public pension issue and hear differing perspectives as to how the pension community should respond."



Keynote speaker: Inspector General Greg Sullivan.



Ethics Workshop at the Forum.

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#### Public Employee Retirement Administration Commission

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## INSPECTOR GENERAL GREG SULLIVAN KEYNOTES FORUM

Inspector General Gregory W. Sullivan was the keynote speaker for the 2006 Forum. Mr. Sullivan provided a history of the creation of the Office of Inspector General. In the late 1970's, in light of the widespread perception that Massachusetts government was for sale, a study was conducted by the Ward Commission. That led to the creation of four significant state agencies: the Division of Capital Asset Management, the Office of Campaign and Political Finance, the State Ethics Commission and the Office of the Inspector General.

The Inspector General, who is appointed by the Governor, Attorney General, and State Auditor, oversees funds relating to programs and operations involving the procurement of any supplies, services, or construction by any state agency, department, board, commission, institution of

higher learning, authority, county, city, or town.

He is committed to "the protection of public confidence in government." His Office has established a confidential toll-free hotline number, 800-322-1323, for reporting suspected fraud, waste, and abuse in government.

Inspector General Sullivan outlined some of the numerous investigations conducted by his Office. Mr. Sullivan made it clear that, while there are instances of fraud and abuse, "public officials deserve to be trusted since the overwhelming number are dedicated and loyal to the people who they serve."

Mr. Sullivan expressed his strong support for the PERAC pension reform effort on Beacon Hill. PERAC's bill, H.

4939, seeks to establish procurement guidelines, debarment of firms that are guilty of infractions, enhanced authority for PERAC to take action when systems violate law or regulations, and mandatory education for retirement board members. Mr. Sullivan commented that "PERAC has done a great job initiating a self-governance review." He noted that the "reforms are very fruitful and thoughtful," that he "endorse(s) them wholeheartedly," and that they "protect against collusion." The Inspector General also praised the PRIM Board, chaired by Treasurer Tim Cahill, for its governance effort and said that "PERAC, Treasurer Cahill, and Auditor DeNucci are seeking to put in place much needed systems and governance," and that "if the Legislature adopts [the bill], it would make things easier for the systems, putting in place clear rules under which to operate."

## EXECUTIVE DIRECTOR CONNARTON SPEAKS ON PENSION BOARD ETHICS

In his welcoming remarks, PERAC Executive Director Joseph E. Connarton reviewed the background that led to this year's topic, stressing several pension related controversies across the nation, from the indictment of a former board member in Illinois for allegedly receiving kickbacks from investment firms to conflict of interest allegations in San Diego. As a result of these and other similar circumstances, retirement boards and their operations have been the subject of increased scrutiny from coast to coast. Connarton noted that this, combined with major funding challenges for pension and post-retirement health care, has fueled a growing movement to eliminate defined benefit pension plans like those in Massachusetts and replace them with defined contribution plans. He cited Michigan, Alaska, California, and South



*Executive Director Joseph E. Connarton.*

Carolina as some of the jurisdictions that either have changed to the defined contribution approach or are contemplating such a change. In Massachusetts, Lieutenant Governor Kerry Healey has announced her intention to file legislation replacing the existing Massachusetts

structure with one based on defined contribution principles. In addition, the Lieutenant Governor, based on a study by the Pioneer Institute, is advocating the consolidation of the present 106 retirement systems into a single system. Connarton acknowledged those actions but stated emphatically, "PERAC is not advocating for one system," and added, "The General Court has charged the Commission with oversight of all of the 106 systems and we will continue to exercise that mandate until the General Court directs us otherwise."

Connarton emphasized that, in light of these trends, it is more important than ever that retirement boards "stay ahead of the curve" and "be proactive, not reactive, forward thinking and innovative."

## PANEL EXPLORES ETHICAL DILEMMAS IN GOVERNMENT

The Forum's morning session was conducted by Dr. Sheldon S. Steinberg, most recently President of International Bridge, Inc., and Mr. David T. Austern, Esq., President of the Claims Resolution Management Corporation and General

Counsel of the Manville Personal Injury Settlement Trust. They covered ethical concepts and principles, elements of maintaining an ethical government practice, the behavioral motivations for unethical practices, and the cost of

unethical practices.

This section was followed by a workshop in which audience members responded to a series of hypothetical work-related **(Continued on page 3)**

## PANEL EXPLORES ETHICAL DILEMMAS IN GOVERNMENT (CONT.)



*Dr. Sheldon S. Steinberg and David T. Austern, Esq.*



*Dr. Dennis E. Logue.*



*Alan P. Cleveland, Esq.*

### **(From page 2)**

ethical dilemmas. The afternoon session, "Principles of Board Governance and the Fiduciary Management and Conflicts-of-Interest of Public Plans," was conducted by Dr. Dennis E. Logue, Chair of the Ledyard National Bank, and Alan P. Cleveland, Esq., of the law firm of Sheehan Phinney Bass + Green. Dr. Logue and Attorney Cleveland took the Forum from a general discussion of ethics in government to specific issues related to retirement board governance and ethics.

Dr. Logue spoke about plan governance principles, guidelines, and structures. He briefly outlined the legal history of pension fund management and administration, enumerated a list of fiduciary duties, catalogued the seven deadly sins of a fiduciary (apathy, cowardice, laziness, ignorance, excessive self-reliance, financial & social self-enrichment, and deception) and outlined some guidelines for public pension plans.

Attorney Cleveland addressed the fiduciary management of conflicts of interest. He delved deeply into the evolution of the guiding principles of ethical conduct, referenced some notorious cases of ethical misconduct, and provided a sobering summary of legal difficulties facing the board members of the City of San Diego pension system.

## INVESTMENT PERSPECTIVES

If there was any silver lining to the lackluster investment returns of the first half of 2006, it was that some of the traditionally more risky asset classes ---like emerging market stocks and small caps--- that performed so well in previous years began to exhibit downside volatility. Nevertheless, investors in those asset classes have been handsomely rewarded over time, and the basic, fundamental themes of investing are still very much intact after having been dramatically validated over the past several years. That is, for a pension fund that has a target rate of return to meet in order to amortize its unfunded liability, investing conservatively in predominantly traditional asset classes with low to moderate perceived volatility can be just as risky as structuring a portfolio over-weighted in high volatility asset classes. That is because the true measure of risk is whether an investor achieves his/her return objectives. Accordingly, the best possible portfolios are those that are as well diversified as possible among both traditional and alternative asset classes and as well balanced as possible between expected risk and expected return. Of course, selection and monitoring of top-tier investment manag-

ers in all asset classes is also a must.

In early June, PERAC invited all the investment consultants who serve our systems to a roundtable discussion in our office for the purpose of exploring ways we can all work together to help Massachusetts' local public retirement systems achieve their investment goals. It was agreed by all that this is a very challenging time for Massachusetts' local public pension systems. The consultants in attendance offered some constructive ideas on possible legislative or regulatory changes that might help their clients and we will follow up on those that are feasible. For our part, we noted that PERAC seeks to work constructively with the local systems in a number of ways. We have consistently stressed the benefits of portfolio diversification in our communications with the systems. Although we have noted in our annual reports that both the investment performance and composite asset allocation of the non-PRIT local systems are in line with those of most national public funds universes, there are virtually no regulatory constraints prohibiting systems from achieving even greater diversification in their asset allocation.

For those alternative asset classes (such as real estate and alternative investments) that do have regulatory limits on maximum asset allocation percentages, boards may request supplemental regulations for the purpose of moderately exceeding those limits. We have also approved supplemental regulations to allow boards to hire managers who might employ instruments (i.e., derivatives) or strategies (i.e., shorting) that may be prohibited under existing regulations or guidelines. In such cases, we carefully consider the appropriateness of the strategy as well as the organizational strength, track record, and risk controls of the manager. Later this year, the Commission will consider whether any changes to our hedge fund guidelines should be made.

Whether in the form of a visit to a retirement board to discuss certain aspects of its investment program or a basic telephone conversation to address issues about the regulatory standing of a proposed investment, the PERAC Investment Unit is committed to working closely and constructively with all systems.

# STATE RETIREMENT SYSTEM VALUATION REPORT

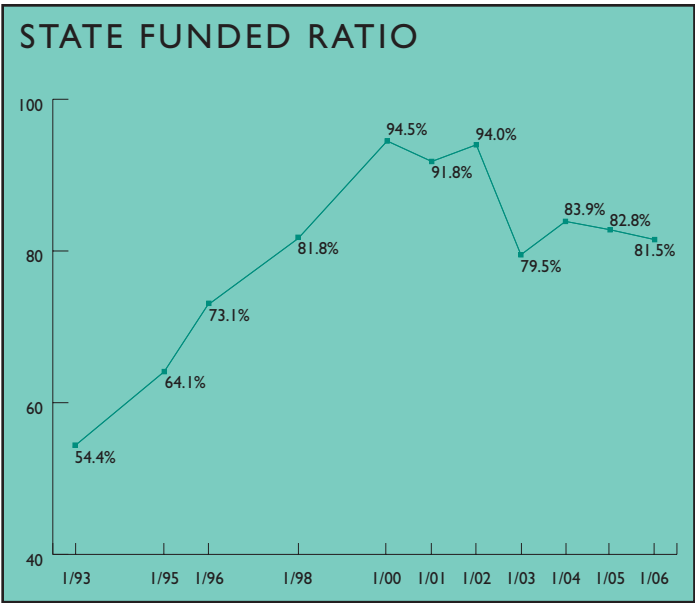
The January 1, 2006 actuarial valuation report of the State Retirement System was completed earlier this year. Two exhibits from that report are shown below.

The charts below detail the Unfunded Actuarial Liability (UAL) and the funded ratio since 1993. The UAL represents the actuarial accrued liability less the actuarial value of assts. The funded ratio

represents the actuarial value of assets divided by the actuarial accrued liability. When there is no UAL, the funded ratio will be 100% and the system is said to be fully funded.



The funded ratio chart provides a better indication of the progress made in funding over the last 13 years. Although the



UAL, as of January 1, 2006 is about the same as it was as of January 1, 1993, plan assets have grown more rapidly than the

actuarial liability over this period.